

Getting it right:

## New regulatory and fiduciary focus on 403(b) plans

OCTOBER, 2010

Rod Bare, Defined  
Contribution Consultant

Dan Gardner, Defined  
Contribution Analyst

*Four key areas for  
403(b) upgrade  
success*

- 1. Streamline  
administration*
- 2. Implement  
robust  
governance*
- 3. Simplify and  
diversify the  
investment  
lineup*
- 4. Improve the  
participant  
experience*

The rules governing defined contribution plans for tax exempt employers (403(b) plans) have undergone considerable change since 2007. In 2007, the Internal Revenue Service completely overhauled the regulatory requirements that 403(b) plans must meet, and imposed substantial new responsibilities on 403(b) plan sponsors and administrators. Employers maintaining 403(b) plans had to quickly adopt new administrative practices similar to those which 401(k) plan sponsors already had in place for a number of years.

Coupled with this change in IRS rules has been a new focus on when 403(b) plans are subject to ERISA, and the impact of ERISA's fiduciary conduct standards on the selection and monitoring of investment options under a 403(b) plan.

Ultimately, particularly for ERISA plans, the goal of a 403(b) plan sponsor should be to provide an opportunity for an adequate retirement standard of living for participants who save appropriately. This means doing right by the participants and providing today's best-in-class retirement investing solutions. "Getting it legal" will become "getting it right."

### **403(b) plans have historically been given a "hands-off" treatment by employers and regulators**

In past decades, 403(b) plans often resembled a hodgepodge of individual employee-provider relationships more than a unified plan. Many employers with 403(b) plans did nothing more than act as a conduit for passing employees' salary reduction contributions to a tax-deferred annuity (TDA). Many times the plan was driven by the relationship between employees and providers – if enough employees wanted a product, the employer would offer it in the plan. Sponsors were happy to outsource administrative duties to providers, who in turn were happy to gain access to participants. It was quite common for a plan to have 10, 20 or more providers on its platform. The products offered often came with heavy loads, as participants paid for administrative as well as investment fees. In all, this could add up to a less-than-ideal situation for participants – it could be difficult to determine which was the most appropriate product to choose, and fees could be high.

Even with the enactment of ERISA in 1974, there was little regulatory pressure on employers offering 403(b) plans. For example, up until 2007, there was limited, often

---

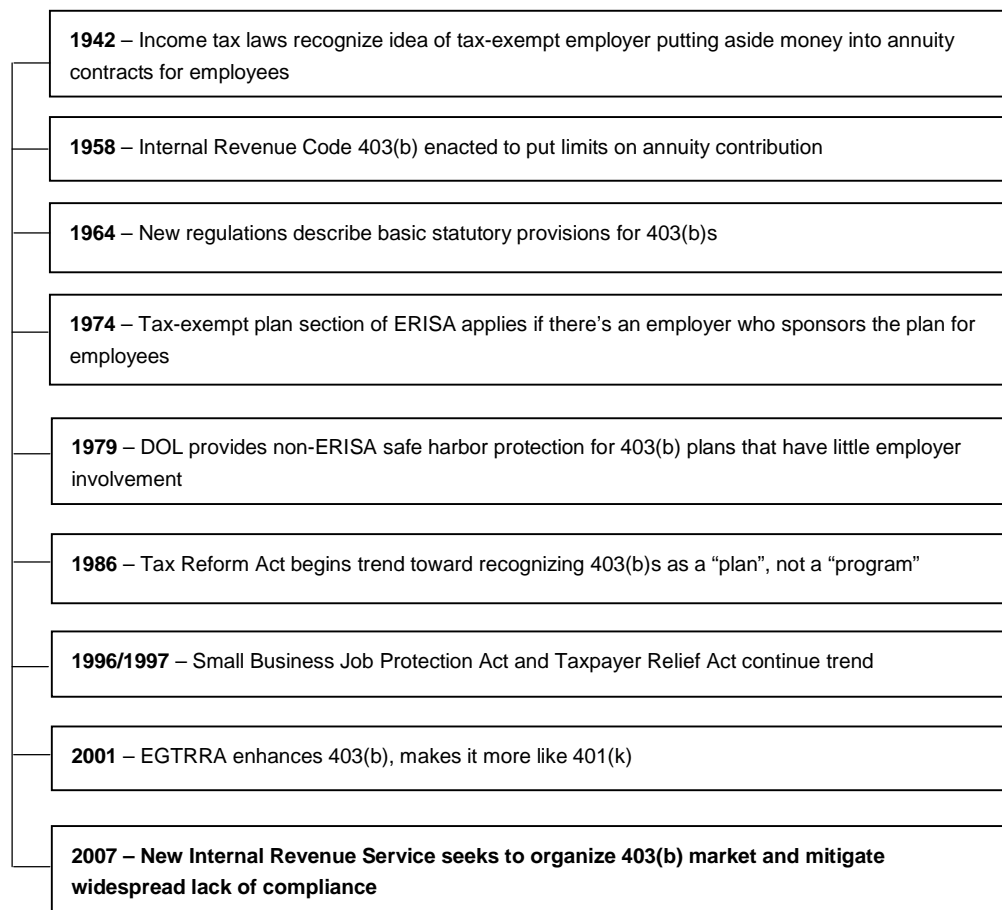
outdated regulatory guidance and the IRS did not stringently enforce the 403(b) plan rules. Plan sponsors could rely on employee representations for tax compliance – including exchanges, loans, hardship withdrawals, contributions, and distributions.

### 403(b)'s start to resemble 401(k)'s, IRS gets wind of non-compliance

Beginning with the Tax Reform Act of 1986 (TRA), 403(b) plans began to more closely resemble 401(k) plans. For example, TRA established non-discrimination rules and imposed a 10% early withdrawal penalty on both 401(k) and 403(b) plans. Further legislation in 1996, 1997 and 2001 continued to increase the similarities between 401(k)s and 403(b)s. Throughout this time, 403(b) plans began to streamline their product lineup.

In the 1990s, the IRS began to discover widespread noncompliance by vendors and participants in 403(b)s. Most plan sponsors were simply payroll facilitators, so there was little employer oversight to ensure tax compliance. For example, there usually was no robust system for reporting participant withdrawals. The lost revenue forced the IRS to take action.

#### Exhibit 1: Timeline of 403(b) legislation and regulation



---

### **2007: IRS finally cracks down, DOL offers guidance**

In 2004, the IRS issued proposed regulations to update and clarify the rules applicable to 403(b) plans and thereby improve compliance. These regulations were finalized in 2007, and generally became effective January 1, 2009. The new regulations added a number of new requirements, including that all 403(b) plans have a written document that includes certain mandatory terms. The new regulations thus required 403(b) plan sponsors to review their plans and operational practices and to make a number of changes. In addition, the revamped regulations provided the IRS with a platform from which to develop a new enforcement initiative targeting 403(b) plan compliance.

Fundamentally, the new regulations required the sponsor to become a bona fide plan administrator, much like a 401(k) plan sponsor. It was no longer acceptable to let vendors and participants operate independently.

In response to the regulations, the Department of Labor (DOL) offered clarifying guidance on the safe harbor exemption from ERISA for 403(b) plans with "limited employer involvement." DOL Field Assistance Bulletin 2007-02 explained that a plan seeking to maintain its non-ERISA status could not permit the sponsor to make discretionary determinations, including authorization of loans and disbursements under the 403(b) plan. This created a grey area for sponsors considering if IRS compliance could remove their non-ERISA safe harbor.

### **Post-2007: plan sponsors ponder shrinking safe harbor, consolidation**

The new regulations and DOL guidance meant that more 403(b) plans fell under ERISA. In recent years, it's become more prevalent in many non-profit sectors to treat an employer's 403(b) plan as subject to ERISA (unless it is a governmental plan, a church plan, or clearly satisfies the "limited employer involvement" criteria). As a result, many plans find that they need help complying with ERISA.

But the biggest effect of the new regulation has been the consolidation of plan vendors to mitigate the sponsor's administrative burden. For example, in January 2009 the \$1 billion University of North Carolina system consolidated from over 50 providers to two.

### **403(b)'s remain a work-in-progress**

While the deadline to comply with new IRS regulations passed early this year, some plan sponsors aren't yet up to speed. The IRS has a compliance initiative in place and is actively examining employers' 403(b) plans in some parts of the country. For plan sponsors who are used to two dozen vendors, getting all their contracts to comply with a unified plan document is a daunting task. Further, many sponsors of 403(b) plans have encountered significant problems in attempting to file a proper Form 5500 this year. Sponsors are having difficulties acquiring necessary data, reconciling reports, and hiring sufficient auditing resources. Discovering unexpected participant assets exacerbates the situation. The deadline to file was October 15, and at least two major trade groups have petitioned for a deadline extension. The IRS understands the issue, and has indicated that they do not intend to reject modified filings.

**Looking into the crystal ball: 403(b) will likely become more like 401(k)**

<b>Comparing 403(b) to 401(k)</b>		
<b>Type of plan</b>	<b>403(b)</b>	<b>401(k)</b>
<b>Number of providers</b>	Potentially dozens	Typically, one
<b>Execution of plan documentation</b>	Only recently under scrutiny	Established as best practice and legal requirement
<b>Number of investment options</b>	Varies, but occasionally hundreds	Typically, 8-25
<b>Typical participant portfolio</b>	Tax-deferred annuity or mutual funds	Target date funds, balanced funds, single asset class funds, stable value funds
<b>Focus on fees</b>	Inconsistent	Recently intensified

From our conversations with lawyers and regulators, we consistently hear the same theme: while 403(b) plans are several years behind 401(k) plans in terms of governance, investment lineups and focusing on outcomes, they will have to catch up. Since sponsors are dealing with compliance issues right now, why not take the opportunity to improve other parts of the plan? Sponsors that realize this now will be ahead of the game.

Many 403(b) plans have not adopted good governance practices. An ERISA plan sponsor has many responsibilities in administering a plan, with an overarching duty to act prudently in the best interest of plan beneficiaries. Good governance in defined contribution (DC) plans means having consistent and organized policies and processes in carrying out the duties associated with meeting this goal. Right now, many 403(b) sponsors are struggling with plan documentation and auditing. The concept of an investment policy statement may be unfamiliar as well. By definition, they cannot be practicing good governance without addressing these items. Unfortunately, participants are the ones that may end up paying the price.

That doesn't mean that 403(b) sponsors are alone. In fact, 401(k) plans have been the subject of increased scrutiny from Washington in recent years. The DOL has issued a number of new regulations affecting defined contribution plans and their sponsors and fiduciaries. The first set of regulations require investment providers, consultants and advisers and certain other service providers to disclose to a plan's fiduciaries information about their services and their direct and indirect compensation. In addition, another set of new DOL regulations require plan sponsors and other fiduciaries to more fully disclose fees and other information regarding the plan's investment options to participants. If the cost of an investment must be clearly disclosed along with its performance relative to a benchmark, participants and sponsors will be able to better realize when they may be paying too much and seek a better solution. In other words, "what gets measured gets managed."

---

This same phrase could apply to the recent plan document and auditing requirements for 403(b) sponsors. By putting plans under a microscope, they are expected to change for the better.

At a high level, retirement plan regulation and guidance from Washington has one goal: getting participants to a better standard of living in retirement. 401(k) plans have been focused on this goal for some time. Possibly the best example of this mindset is the innovation of target date funds, investment products designed to deliver adequate income to participants in retirement. Since the market crash of 2008, Washington has ramped up its focus on retirement income options, particularly target date funds. While 403(b) plans are still getting up to speed, they too will have to upgrade plan governance and procedures over the coming years.

### A guide to getting it right for plan sponsors

As we've discussed, 403(b) plan sponsors are feeling pressure from the IRS and the DOL to comply with new regulatory and fiduciary standards. These standards are expected to become even more detailed and stringent in the future. A great way to gain insight on how to handle these issues is to learn from the experience of others who've been in the same situation. In March, 2010, Paul Lasiter, CFO of Pepperdine University, penned an article called "Single Provider, Multiple Choices." In it, Lasiter described the process of migrating the university's plan from a multi-provider platform to a single provider, open architecture platform.<sup>1</sup> Undergoing this procedure allows a plan to cut costs and yet offer best-in-class funds to participants. Based on his experience and our own observations, we've prepared a four step process plan sponsors can follow to build their 403(b) plans – up to the level we think will become standard.

#### 1. Get the administration right.

- Examine the plan's structure: Can the plan streamline administrative duties, either by reducing the number of providers or through more efficient processes? Which services could be outsourced? Does the plan allow for open architecture, or does it exclusively use proprietary funds (it's hard for a single manager to be best at all asset classes)?
- Ramp up compliance capabilities: Is the plan prepared to file Form 5500s/audited financial statements and comply with new reporting requirements for fees and expenses? If it has multiple vendors, is there a system for tracking the information needed for filing? Has it hired sufficient auditing resources? Is the plan willing to subject itself to an audit of "legacy" assets (N.B. the IRS does offer transition relief for these assets)?
- In the case of consolidation, consider how assets will be transitioned: Does the plan want to preserve some current offerings? Should participants have the option to maintain existing assets? Will existing vendors impose surrender charges on assets? Who would pay these charges?
- Seek professional advice: Does the plan have expertise on best practices associated with plan consolidation? If not, has it prepared a formal request for proposal to potential consultants/advisors?

---

<sup>1</sup> The entire article can be viewed here:

[http://www.nacubo.org/Business\\_Officer\\_Magazine/Magazine\\_Archives/March\\_2010/Single\\_Provider\\_Multiple\\_Choices.html](http://www.nacubo.org/Business_Officer_Magazine/Magazine_Archives/March_2010/Single_Provider_Multiple_Choices.html)

---

## **2. Get the investment policy statement right and follow through on it.**

- Have an investment policy statement in place, and review it if you already have one.
- Think through how to execute it: How is the investment committee set up? What role will other resources in the organization play? What's the process for selecting options in the plan?
- Execute what's been put in place: Is the plan correctly following the guidelines in the statement? Are there any organizational or behavioral obstacles to choosing the best options for participants?

## **3. Get the investment lineup right.**

- Choose the right managers: How will you select best-in-class managers for participants? Will you go with all passive, all active or a combination, and is this decision in the best interest of participants?
- Examine the investment lineup and search for ways to simplify: Are components of the lineup redundant? Is the sponsor willing to undertake the due diligence necessary to offer a diverse lineup? How will offerings be evaluated (what are the benchmarks), and how often will performance reviews occur?
- Take a hard look at provider compensation: How should the provider(s) be compensated? What revenue does the provider receive from the plan? Does the provider have any incentive to push participants towards higher expense funds? Has the provider given the sponsor or other responsible fiduciaries all of the compensation information that is required by law to disclose?
- Again, seek professional advice: Does the plan have resources to properly evaluate the quality of the funds and competitiveness of fees? If not, has it prepared a formal request for proposal to potential consultants/advisors?

## **4. Get the participant experience right.**

- Know the plan's participants and prepare them for the new plan: Will the plan address participants' concerns early on and provide support and education? Are new vendor(s) equipped to handle participant communication issues? How will participant reports look?
- Help participants save enough for retirement: What is the plan's participation rate and average contribution rate? Has the plan considered auto enrollment and auto escalation? If so, has it identified an appropriate default investment option, such as a target date fund? How do you know if participants are on track for a comfortable retirement?

## **Conclusion**

403(b) plan sponsors have been jolted into a new era of compliance. They face a difficult task in implementing DC best practices in the years to come. The best way to tackle this problem is to take action now. Getting the plan's administration, governance, investment options and participant experience to where they need to be will pay off in a big way. For 403(b) plan sponsors, best practice is what's best for participants.

---

**For more information:**

Call Russell at **800-426-8506** or  
visit **[www.russell.com/institutional](http://www.russell.com/institutional)**

**Important Information**

---

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Target date funds are not intended to be a complete solution to investors retirement income needs. Investors must weigh many factors when considering to invest in these funds, including how much an investor will need, how long will the investor need it for, what other sources the investor will have and, if the investor is purchasing shares in an IRA account, whether the fund's target distributions will meet IRS minimum distribution requirements once age 70 1/2 is reached.

Russell Investment Group, a Washington USA corporation, operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments 2010. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

First used: October, 2010

USI-8067-10-12